2005 M&A Report

WILMERHALE

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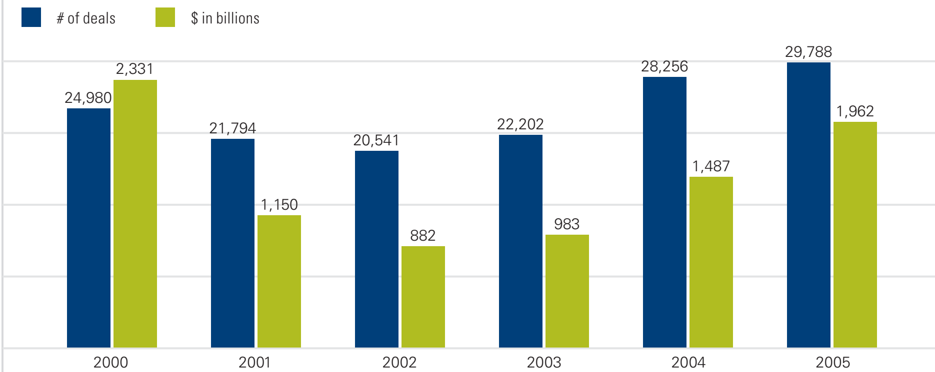
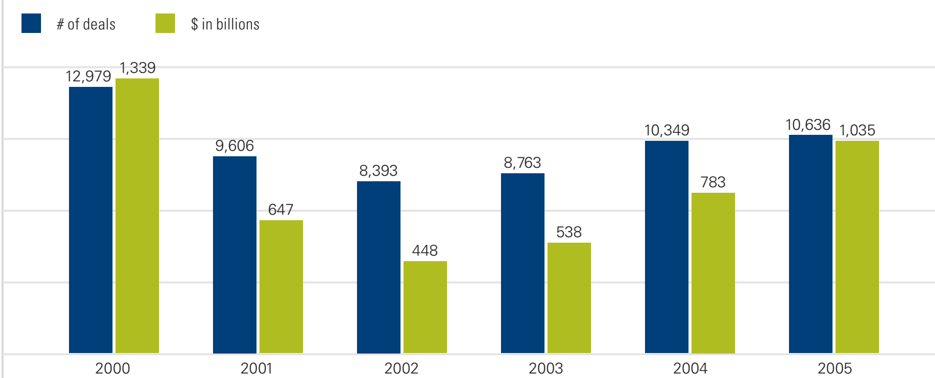
M&A Activity – Worldwide



Source: MergerStat

M&A Activity – United States



Source: MergerStat

2005 Review

Merger and acquisition activity remained strong in 2005, with global M&A deal volume up from 28,256 in 2004 to 29,788 in 2005. More significantly, global M&A deal value ballooned 32%, from $1.49 billion in 2004 to $1.96 trillion in 2005. Deal value in 2005 was only 16% below the record $2.33 billion deal value in 2000, at the peak of the Internet boom.

Average deal size based on M&A transactions where the price was disclosed rose from $126.9 million in 2004 to $153.6 million in 2005. The fourth quarter of 2005 saw the highest average deal size—$171.1 million—and was the seventh successive quarter in which average deal size grew.

US M&A activity largely mirrored global trends. The US M&A deal volume of 10,636 in 2005 barely surpassed the 10,349 deals in 2004. However, US deal value jumped by almost a third, from $783 billion in 2004 to $1.04 trillion in 2005. Average deal size increased from $202.3 million to $243.6 million. The 2,440 deals announced in the fourth quarter of 2005, however, marked the lowest quarterly total since the fourth quarter of 2003, suggesting that deal flow may be stabilizing at 2005 levels.

European M&A deal volume increased 7% to 12,110 in 2005, up from 11,293 in 2004 and only slightly below the 2000 total of 12,923. Total deal value rose from $636 billion in 2004 to $871 billion in 2005. Average deal size clocked in at $205.8 million in 2005, up from $165.5 million in 2004.

M&A activity in the Asia-Pacific region continued its upward trajectory, with 9,099 M&A deals in 2005 compared to 8,364 in 2004. Aggregate deal volume increased from $261 billion to $318 billion, while average deal size rose from $54.8 million to $61.8 million.

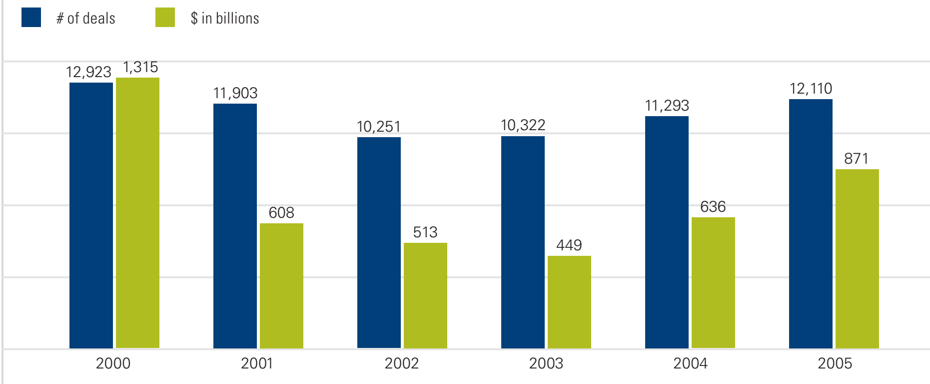
The increases in average deal size are primarily due to the growth in the number of billion-dollar transactions worldwide. Globally, the number of billion-dollar transactions spiked by 45%, from 236 in 2004 to 345 in 2005. Aggregate global billion-dollar deal value rose from $897 billion in 2004 (60% of total global deal value) to $1.28 trillion in 2005 (65% of total global deal value). US billion-dollar transactions were up 26%, with aggregate deal value increasing by almost a third, from $497 billion in 2004 (64% of total US deal value) to $710 billion in 2005 (69% of total US deal value). Billion-dollar transactions involving European companies experienced the strongest growth from 2004 to 2005—the number of deals soared by 70%, from 99 to 170, and the aggregate deal value increased 58%, from $361 billion to $569 billion.

Cash and combined cash and stock transactions still predominated in 2005. Most notable was the increase in cash deals with acquisition prices in excess of $1 billion. These very large cash deals were up more than 60%, from 106 in 2004 to 171 in 2005, underscoring the ready availability of acquisition capital.

Private equity played a major role in the M&A market in 2005. Although not new to the M&A market, private equity buyers increasingly sought technology targets—in deals like the $1.1 billion cash purchase of DoubleClick by Hellman & Friedman—or teamed up to fund mega-deals, such as the $10.4 billion cash acquisition of SunGard Data Systems by the consortium of Silver Lake Partners, Bain Capital, Blackstone Group, Goldman Sachs Capital Partners, Kohlberg Kravis Roberts, Providence Equity Partners and Texas Pacific Group.

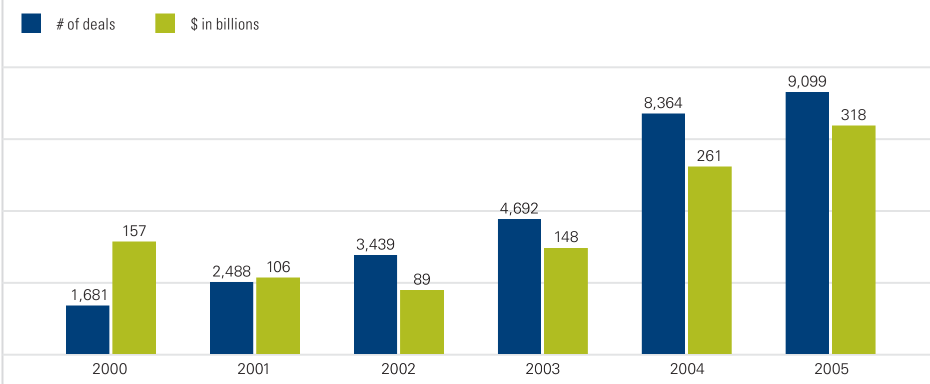
There were 127 going-private deals announced in the United States in 2005—the highest number in at least seven years—as the increasing burden and expense of public ownership, combined with an influx of private equity buyers, prodded more public companies into private ownership.

M&A Activity – Europe



Source: MergerStat

M&A Activity – Asia-Pacific



Source: MergerStat

Sector Analyses

Much of the strength of the 2005 M&A market can be attributed to the vitality of several technology sectors.

Information technology was the most active global sector in 2005. The total number of IT deals increased 8%, from 3,820 in 2004 to 4,138 in 2005. Global IT deal value jumped 64%, from $69.4 billion to $114.0 billion—although it was still less than half the $230.3 billion total in 2000. The largest IT transactions announced in 2005 were the $10.4 billion SunGard acquisition and Oracle's $5.6 billion agreement with Siebel Systems. The fourth quarter of 2005 produced 1,101 IT deals, the highest quarterly number since the first quarter of 2001.

US IT deal volume remained almost flat in 2005, with aggregate deal volume edging up 2% from 2,045 to 2,085. US aggregate IT deal value posted a 71% year-on-year gain, with deal value rising from $52.0 billion in 2004 to $88.9 billion in 2005.

The number of global M&A transactions in the life sciences sector increased less than 5%, from 983 in 2004 to 1,028 in 2005. Global life sciences deal value declined from $138.5 billion to $106.5 billion, although the decrease can be attributed to the $66.3 billion (€48.6 billion) bid in 2004 by French pharmaceuticals company Sanofi-Synthelabo for Aventis.

The US life sciences sector saw a 17% bump in deal volume, from 422 in 2004 to 494 in 2005. Aggregate US life sciences deal value was 60% higher in 2005 ($85.1 billion) than in 2004 ($52.7 billion).

After three consecutive years of growth, the number of telecommunications M&A transactions declined globally and in the United States. Global deal volume slipped 7%, from 1,159 in 2004 to 1,083 in 2005, and US deal volume fell 6%, from 432 to 408. Global telecommunications deal value, however, rose from $187.1 billion to $199.3 billion, led by Telefonica's $31.0 billion (€26.2 billion) friendly tender offer for O2.

US aggregate telecommunications deal value dropped 38%, from $115.8 billion in 2004 to $71.9 billion in 2005—however, the 2004 figure was buoyed by the $40.9 billion BellSouth/SBC deal for AT&T Wireless Services and Sprint's $28.4 billion agreement with Nextel.

The global financial services sector saw a slight increase in deal volume, from 1,661 in 2004 to 1,756 in 2005, although aggregate deal value fell 23%, from $280.8 billion to $215.3 billion. Deal value in 2004 was, however, supported by a number of multibillion-dollar deals, led by

JPMorgan Chase's $57.6 billion agreement with Bank One. In contrast, the largest financial services M&A deal of 2005 was Bank of America's agreement to acquire MBNA for $34.5 billion in cash and stock.

The US financial services sector declined in both deal volume (which was down from 657 in 2004 to 615 in 2005) and aggregate deal value (which dropped from $143.6 billion to $102.2 billion), despite the Bank of America/MBNA deal.

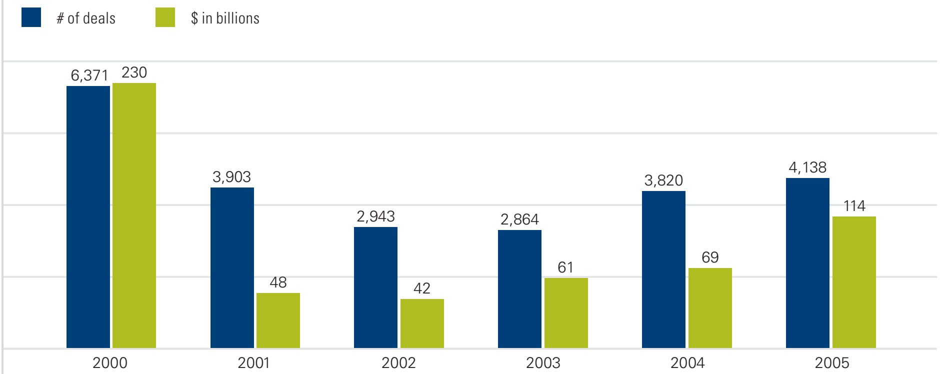
The M&A market for venture-backed companies enjoyed higher sale prices on modestly lower deal volume in 2005. Although there were only 356 acquisitions of venture-backed companies in 2005, compared to 407 in 2004, the median acquisition price increased for the fourth consecutive year, from $39.3 million to $47.5 million. While this figure is well below the median acquisition prices in 1999–2000—including the staggering $100 million median in 2000—it is higher than the median acquisition prices in the 1996–1998 timeframe. In 2005, the median time from initial funding to an acquisition was 5.4 years, almost a year longer than in 2004, and the highest figure since 1996.

2006 Outlook

We believe the strong 2005 M&A results are attributable to a variety of factors, including:

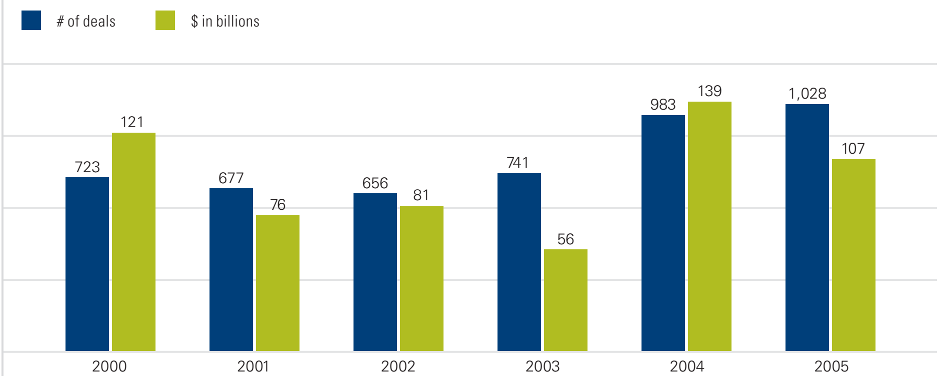
- the overall strength of the US and world economies;
- increased corporate profits and cash balances among buyers;
- stable debt and equity markets;
- for some public company targets, the decreased attractiveness of remaining public due to the cost of complying with Sarbanes-Oxley and other new regulatory requirements;
- the desire of strategic buyers to rapidly acquire new technologies and gain market share;
- the abundance of private equity money, fueled by interest rates that remain low and debt availability that remains high by historical

M&A Activity – Information Technology



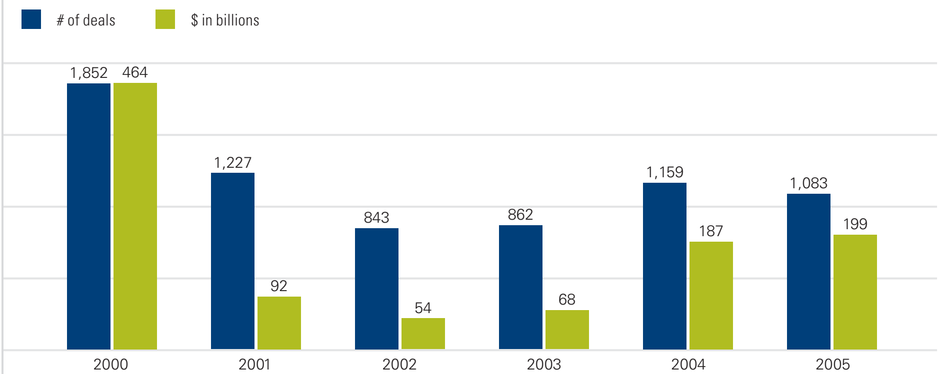
Source: MergerStat

M&A Activity – Life Sciences



Source: MergerStat

M&A Activity – Telecommunications



Source: MergerStat

standards, often enabling buyout firms to outbid strategic buyers; and

- in the case of VC-backed private companies, less favorable IPO conditions coupled with more attractive sale valuations.

We believe these factors will remain drivers of the 2006 M&A market. The economy remains strong, interest rates—though higher than last year—remain at historically low levels, and capital is widely available to finance M&A deals.

The outlook for technology companies, in particular, continues to be favorable. Technology M&A led the market increases in 2005 and shows no sign of slowing in 2006.

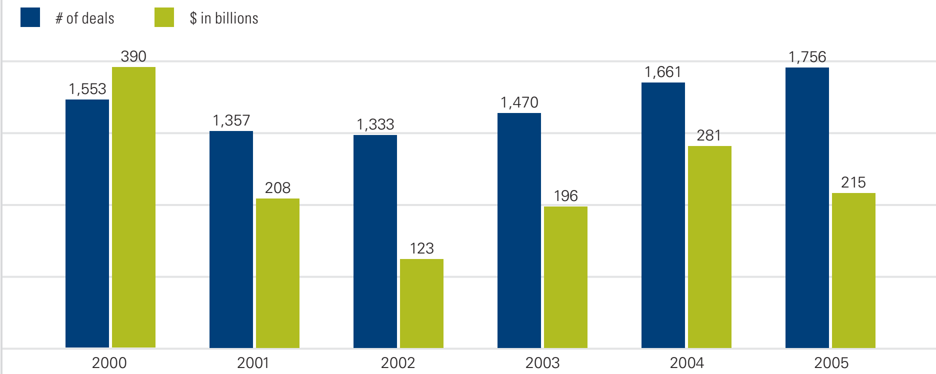
Sizable new private equity funds were established in 2005 for M&A activity, and private equity participants also partnered with each other and with strategic investors on deals. Competition between private equity and strategic buyers has sweetened the multiples being paid for attractive targets. There is every indication that these trends will continue or accelerate in 2006.

For many private companies, an M&A transaction is the exit vehicle of necessity as a result of the slow IPO market. Unlike several years ago, many of these private companies have strong balance sheets and are attractive M&A targets. Similarly, both publicly and privately held companies are stronger financially than they have been in recent years, and now have the opportunity to consider M&A activity as a growth option.

Although the M&A trends remain positive, and 2006 looks to present another favorable year for M&A activity, no one is predicting a return to the record levels of the 2000 M&A bubble. The changes implemented by Sarbanes-Oxley have resulted in increased due diligence, longer time periods to complete deals, higher transaction costs and a greater degree of caution and scrutiny in M&A transactions. ■

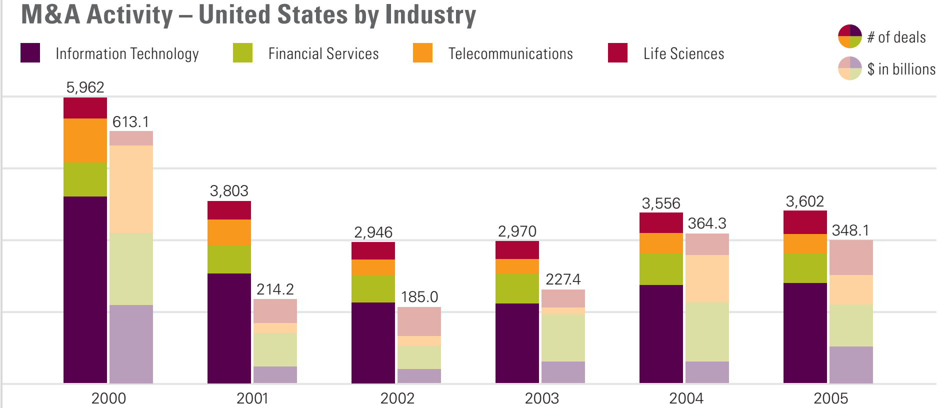
January 2006

M&A Activity – Financial Services



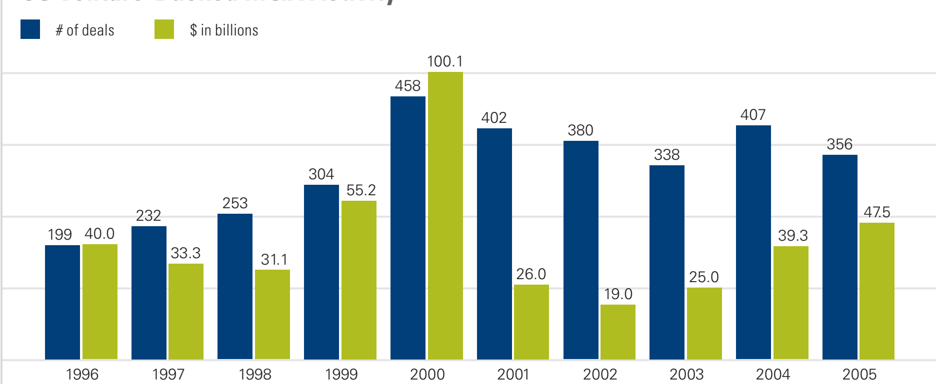
Source: MergerStat

M&A Activity – United States by Industry



Source: MergerStat

US Venture-Backed M&A Activity



Source: VentureOne

The Hart-Scott-Rodino Act (HSR Act) requires parties to a merger or acquisition meeting certain size thresholds—generally, at least $50 million ($56.7 million as of February 17, 2006)—to report their transaction to the Federal Trade Commission (FTC) and the Department of Justice (DOJ) and to observe the prescribed waiting period. Observance of the HSR waiting period is a significant enforcement issue at both the FTC and the DOJ.

Antitrust Gun Jumping

Most parties understand that they are prohibited from actually closing the transaction until the HSR waiting period expires or is terminated. The antitrust laws, however, also regulate the merging parties' interaction during this period.

In their haste to prepare themselves for life post-merger, parties can cross the line between permissible preparation for integration and impermissible transfer of control. Parties that breach the waiting period—through conduct known as "gun jumping"—can be charged with violations of the Clayton, Sherman and FTC Acts, and can find their transaction bogged down in a completely collateral investigation.

The length of the HSR review process—which can involve two waiting periods—often creates a tension between the need to observe the HSR requirements and the need to prepare for integration of two independent companies.

Antitrust Waiting Periods

The first waiting period, applicable to all reportable transactions, imposes a 30-day moratorium on closing the transaction, while the reviewing agency conducts what is typically only a brief review of the HSR filing. If the transaction appears to raise antitrust concerns, however, the initial review may involve analyzing market share data, contacting customers, examining the business plans of the parties, and interviewing key personnel from the parties. If the agency believes that the transaction will not "substantially lessen competition," it can either terminate the waiting period before the expiration of the 30 days or allow the waiting period to expire on the 30th day.

If—after the initial review—the reviewing agency believes the transaction raises competitive concerns, or if more time is needed to investigate properly, the reviewing agency can extend the waiting period by issuing a "Second Request," which typically involves the production of a substantial amount of additional documents, information and economic analyses. A Second Request can extend the waiting period for large transactions raising significant competitive issues by several months or more.

Furthermore, in many transactions—particularly those involving public companies requiring shareholder approval to complete the deal—closing may not take place until months after HSR approval is received. While the HSR clock ticks away, the parties must continue to act as independent entities, even while they prepare to marry the two companies at closing.

Integration Planning Needs

In the time between execution of an acquisition agreement and closing of the transaction, the parties have a legitimate need to prepare to integrate their operations:

- The parties want to hit the ground running when the transaction closes. The ability of the combined company to compete on day one may depend on the seamless transition of control from the acquired party to the acquiring party, or from both parties to the new merged firm, without disruption to either party's businesses.
- The acquired company may be concerned that its key employees will abandon the company, thereby rendering the company an ineffective competitor until the transaction closes. Of course, the acquiring party has an equally compelling interest in preventing the devaluation of the business it is about to acquire.
- The benefits that result from the transaction may diminish if the parties are required to wait a long period until closing before they can prepare to integrate operations.

The antitrust agencies generally are sympathetic to these needs. At the same time, they have a mission to enforce the antitrust laws, which includes preventing competitors from coordinating their competitive activities. In the view of the antitrust agencies, parties to a pending transaction that are competitors are still competitors, and must act like competitors until the HSR process is cleared and the transaction closes.

Integration DO's and DON'Ts

While parties should seek the advice of counsel regarding activities undertaken in connection with any specific transaction, the following are general guidelines to avoid alleged gun jumping offenses:

- **DON'T** agree on prices or other terms of sale.
- **DON'T** allocate markets between the parties. This means, for example, that parties that compete for business through bids should continue to bid for customers according to their plans that were established before merger negotiations began. One party should not withdraw from a bid simply because its merger partner is a competing bidder.
- **DO** share only that information which is necessary for normal due diligence purposes and assessment of future integration. Try to avoid sharing prices or other competitively sensitive information. Regardless of the sensitivity of the information, limit its dissemination to those who need the information to conduct normal due diligence. If pricing or other highly sensitive information must be shared, try to limit its dissemination to employees of the other party who are not involved in setting prices for that party.
- **DON'T** swap employees or assign employees from one party to the other.
- **DON'T** reorganize or otherwise assign responsibility of one party's business to the employees of another party. For example, if the acquired party will fall

under the responsibility of a particular employee, that employee should not assume managerial responsibility for the acquired party until the transaction is completed.

- **DON'T** involve the employees of one party in the decision-making processes of the other party. Business and strategic plans of one party should not require the review and approval of another party. Nor should one party have control over whether the other party pursues the business of certain customers.
- **DON'T** make employment decisions that will motivate employees to abandon the acquired party. For example, if there are only a few key employees that will be needed post-merger, the acquiring party should not notify the other employees that the merged firm would not employ them. This does not prevent the acquiring company from offering retention bonuses to key employees in an effort to keep those employees from leaving the company before the transaction is completed.
- **DO** be careful of attempts on the part of the acquiring party to exercise control over the business decisions of the acquired company. Don't go beyond what is necessary to monitor compliance with provisions in the merger agreement requiring the acquired company to conduct its business in the ordinary course and similar matters. Restrictions imposed on the acquired party to protect the investment of the acquiring party—relating to asset sales, pledges of securities as collateral, entry into new lines of business, incurrence of significant debt and similar matters—are considered legitimate.
- **DO** maintain separate identities. For example, neither party should change its name to that of the other party or the new merged firm.

In sum, restrictions on pre-closing activities can be frustrating to parties facing an extended HSR review or post-HSR period before closing. With proper guidance, however, parties should be able to achieve most of their pre-closing goals without undue risk of gun jumping violations. ■

Recent Enforcement Actions

Over the past decade, the FTC and DOJ have reviewed more than 25,000 mergers. The agencies are mindful that many forms of pre-merger coordination are reasonable and necessary, and that care must be taken not to unduly jeopardize the ability of merging companies to implement their transaction and achieve available efficiencies. Still, during this period, the FTC has brought six cases against merging companies that "jumped the gun" by engaging in excessive coordination before closing.

Two recent enforcement actions—one involving egregious conduct and the other a more subtle exercise of control—illustrate some of the potential dangers and liabilities of pre-closing conduct that the agencies continue to find impermissible.

Example A

Two competitors sought to resolve patent litigation between them by forming a joint venture (JV) to run competing services offered by both companies. The JV negotiations fell through, and the parties eventually agreed to merge. The DOJ alleged that, beginning with the JV negotiations, the parties took the following actions in violation of the Clayton Act:

- The parties entered into a "slow roll" agreement, under which both parties agreed to delay final bids for business each was competing to win until after their merger closed.
- The parties allocated product markets between themselves. One party agreed that it would no longer focus on providing its service to one group of customers and would instead focus on another group of customers, while the other party continued to focus on the first group.
- The parties allocated specific customers between themselves.
- During the JV negotiations, the parties had created a term sheet that included prices the JV would charge. Upon entering into the merger agreement, the parties agreed that each would adhere to this standard term sheet.
- The parties shared detailed, customer-specific information about offers and counteroffers and kept each other informed about customer contacts.
- New agreements that one party entered into with customers reflected many of the same terms that were used in the other party's agreements.
- One party reviewed and approved the other party's contracts with customers, requests for extensions of deadlines for price discounts, and responses to counteroffers by customers.
- An officer of one party handled negotiations to settle litigation between the other party and an unrelated third party.
- The parties shared information about the pricing and availability of advertising space on each other's services.

The parties settled the case, agreeing to pay more than $5 million in fines—representing the maximum statutory penalty under the HSR Act.

Example B

A provision in the merger agreement between two companies required the target company to obtain the acquiring company's prior approval in order to:

- offer discounts greater than a specified percentage;
- vary the terms of customer contracts from an agreed-upon standard form contract;
- offer certain services beyond 30 days at a fixed price; or
- provide a specified type of service.

The acquiring company also installed a company officer on site at the target company's premises to review and approve customer contracts.

After the DOJ brought an enforcement action, the parties settled by paying a fine in excess of $500,000.

Counsel of Choice for Mergers and Acquisitions

SERVING INDUSTRY LEADERS IN TECHNOLOGY, LIFE SCIENCES, FINANCIAL SERVICES, COMMUNICATIONS AND BEYOND

Avid	*acquisition of*	Pinnacle Systems	$462,000,000	August 2005
DoubleClick	*acquisition by*	Hellman & Friedman	$1,100,000,000	July 2005
RSA Security	*acquisition of*	Cyota	$145,000,000	December 2005
eyetech	*acquisition by*	OSI Pharmaceuticals	$935,000,000	November 2005
Imagitas	*acquisition by*	Pitney-Bowes	$230,000,000	May 2005
PerkinElmer	*sale of aerospace business to*	Eaton	$333,000,000	December 2005
Lionbridge	*acquisition of*	Bowne Global Solutions	$193,000,000	September 2005
IDX	*acquisition by*	GE Healthcare	$1,200,000,000	January 2006
verizon	*acquisition of*	MCI	$8,500,000,000	January 2006 (regulatory counsel)
Thermo Electron Corporation	*acquisition of*	Kendro Laboratory Products	$833,500,000	May 2005
Saucony	*acquisition by*	Stride Rite	$170,000,000	September 2005
SBC	*acquisition of*	AT&T	$16,000,000,000	November 2005 (regulatory counsel)
Kadant (An Accent on Innovation)	*acquisition of*	The Johnson Corporation	$102,000,000	May 2005
Brooktrout	*acquisition by*	EAS Group	$173,000,000	October 2005
BAE Systems	*acquisition of*	United Defense Industries	$4,192,000,000	June 2005 (regulatory counsel)
Autonomy	*acquisition of*	Verity	$500,000,000	December 2005
SS&C	*acquisition by*	The Carlyle Group	$941,000,000	November 2005
Danaher	*acquisition of*	Leica Microsystems	$550,000,000	September 2005 (co-counsel)
Savient Pharmaceuticals, Inc.	*sale of global biologics manufacturing business to*	Ferring	$80,000,000	July 2005
FTI	*acquisition of*	Competition Policy Associates	$70,000,000	January 2006
Blackboard	*acquisition of*	WebCT	$180,000,000	Pending*
BESI	*acquisition of*	Datacon Technology	€72,600,000	January 2005
Spaulding & Slye (A member of the Jones Lang LaSalle group)	*acquisition by*	Jones Lang LaSalle	$150,000,000 (plus earnout)	January 2006
GoldPocket Interactive	*acquisition by*	Tandberg Television	$78,500,000	November 2005
Akamai	*acquisition of*	Speedera Networks	$130,000,000	June 2005
TKT (Transkaryotic Therapies)	*acquisition by*	Shire Pharmaceuticals	$1,600,000,000	July 2005
TUI Aktiengesellschaft	*acquisition of*	CP Ships	$2,000,000,000	October 2005 (US and EU securities and antitrust counsel)
mks (Technology for Productivity)	*acquisition of*	Ion Systems	$70,000,000	January 2006
Staples (that was easy.)	*acquisition of*	Prime Office Products	Undisclosed	September 2005
Watts Water Technologies	*acquisition of*	Dormont Manufacturing	$94,500,000	December 2005
Oracle	*acquisition of*	Siebel Systems	$5,850,000,000	Pending* (EU antitrust co-counsel)
SallieMae	*acquisition of*	GRP Financial Services	$137,000,000	August 2005
LiveVault corporation	*acquisition by*	Iron Mountain	$50,000,000	December 2005
HSBC (The world's local bank)	*acquisition of*	Metris Companies	$1,600,000,000	December 2005

* as of January 11, 2006

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In addition to the deal structuring issues that typically arise in connection with any acquisition, M&A transactions involving a party incorporated or based in California raise a number of special issues and opportunities. Some of these issues affect permissible deal terms, deal structure and the manner in which a deal is consummated, and others apply generally to California employees.

Companies looking to expand into California, particularly technology companies interested in taking advantage of the state's high-tech workforce, need to be mindful of several unique aspects of doing business—and doing deals—in California.

Deal Lockups

Since the Delaware Supreme Court's decision in *Omnicare* in 2003 limited the ability of an acquiror to guarantee deal approval by means of voting agreements, there has been a growing trend in California private company acquisitions toward simultaneous "sign-and-close" and "sign-and-vote" transaction structures. In the former, the closing occurs concurrently with the initial signing of the acquisition agreement. In the latter, shareholders provide the requisite shareholder approval by written consent in lieu of a meeting, at the same time that the definitive acquisition agreement is signed.

California courts have not addressed the subject of deal lockups, so it is unclear whether California would follow *Omnicare* at all. But in any event, California law gives California corporations more flexibility than Delaware law in obtaining merger approval from shareholders.

Under Delaware law, shareholder written consents cannot be signed and delivered until after the merger agreement has been signed and sent to shareholders. This inevitably means a delay between signing and the receipt of shareholder approval. The delay can be short—as little as a few hours, possibly less—but Delaware's strict sequencing requirement still creates a window of risk during which the deal is not "locked up" and a competing bidder could derail a transaction.

Unlike Delaware law, California law does not require a signed merger agreement to be adopted by shareholders, but only requires shareholder approval of the "principal terms" of the merger. Shareholder approval can occur before or after board approval of the merger and the signing of the merger agreement. Where the target is a California corporation, shareholder approval can be exactly simultaneous with the signing of the definitive agreement—and can even precede the signing of the definitive agreement as long as the principal terms of the transaction do not change after shareholder approval.

Business Combinations

California corporate law has a number of other provisions that may affect business combination transactions, including merger, going-private and leveraged buyout transactions:

- Section 1101 of the California Corporations Code requires that, in a merger involving a California corporation, all shares of the same class or series of any constituent corporation be "treated equally with respect to any distribution of cash, rights, securities, or other property." This requirement is potentially stricter than the comparable rules in Delaware, which have been interpreted—at least in some cases—to allow different forms of payment (such as cash instead of stock) to be made to different holders of the same class of stock, as long as equivalent value is paid and minority stockholders are not disadvantaged.

- Section 1101 also limits the ability of an acquiror in a "two-step" acquisition transaction (i.e., a tender offer followed by a second-step merger) to cash out untendered minority shares. If an acquiror holds more than 50% but less than 90% of a California target's shares, the target's non-redeemable common shares and non-redeemable equity securities may only be converted into non-redeemable common shares of the surviving or acquiring corporation. This means that, in all-cash or part-cash two-step acquisitions of California corporations, the minimum tender condition needs to be 90%, which can be a difficult threshold to reach.

- Under Section 1203, an "affirmative opinion in writing as to the fairness of the consideration to the shareholders" of the subject corporation is required in transactions with an "interested party" (as defined by the statute). The statute is not confined to an opinion as to the fairness of the consideration "from a financial point of view"—the normal formulation in an investment banking fairness opinion—and it is unclear whether, and in what circumstances, a more extensive opinion may be required in a transaction subject to the statute.

- Several sections of the California Corporations Code restrict dividends and distributions to shareholders, as well as redemptions and share purchases. In general, these provisions are significantly more restrictive than the comparable provisions of Delaware law, and may require structural solutions where compliance does not meet business objectives.

"Quasi-California" Corporations

Section 2115 of the California Corporations Code—the so-called "quasi-California" corporation statute—purports to apply various California corporate law requirements to corporations incorporated in other states, including Delaware, if specified tests are met. The law applies to private companies, as well as public companies whose shares are not listed on the NYSE, AMEX or Nasdaq National Market.

Although a Delaware court has held that Delaware law trumps California law as applied to a Delaware corporation, Section 2115 was upheld by a California intermediate appellate court in the 1980s and has not been seriously challenged since. We therefore believe it would be imprudent for a non-California corporation to ignore this statute, since the application of the statute to out-of-state corporations may depend on a race to the courthouse.

Delaware Updates Guidance on Acceptable Deal Protections

In 2005, the Delaware courts provided further guidance on acceptable deal protections in Delaware.

The landmark *Omnicare* case held in 2003 that deal protection mechanisms in mergers must be both reasonable and not preclusive. *Omnicare* illustrated the extreme end of "preclusiveness"—the deal protections in question made it impossible for any subsequent offer to succeed:

- The merger agreement could not be terminated by the target if a higher bid emerged.
- The transaction had to be submitted for stockholder approval, even if the target's board changed its recommendation as to the advisability of the transaction.
- Stockholder approval was assured because stockholders holding a majority of the target's outstanding shares had agreed in advance to vote in favor of the merger.

In the 2005 *Toys "R" Us* case, the Delaware Court of Chancery endeavored to "provide guidance to transactional lawyers on the acceptable level of deal protections" in transactions where a substantial part of the consideration is cash or where the deal involves a breakup of the target (a so-called "*Revlon*" transaction). Since a board's obligation in these situations is to get the best price for stockholders, deal protections—which may discourage higher bids—are subjected to a higher degree of scrutiny.

In *Toys "R" Us*—following a seven-month public auction for a division of Toys "R" Us and based on interest from a leading bidder in acquiring the entire company at an attractive price—the board solicited bids to acquire the entire company from the four top bidders in the divisional sale auction. The Toys "R" Us board ultimately agreed to sell the company at a substantial premium to the market price. The merger agreement included the following deal protection mechanisms:

- a standard "no shop" provision that prohibited solicitation of, but allowed consideration of, unsolicited superior proposals;
- a termination fee equal to 3.75% of the equity value;
- an agreement to reimburse the buyer's fees—capped at 0.5% of equity value—in the event that the target's stockholders voted against the transaction, whether or not a competing transaction had been announced; and
- a matching right for the buyer in the event of a topping bid from another acquiror.

The plaintiffs in *Toys "R" Us* criticized the board for converting the auction from a divisional sale to a sale of the entire company late in the process, and for limiting the bidders for the entire company to the four highest bidders in the divisional sale auction. The plaintiffs argued that the deal protection mechanisms granted were not reasonable in the context of a sale of the company, in light of the imperfect auction process.

The court rejected the plaintiffs' claims and upheld the deal protection mechanisms. The following lessons can be learned from the court's ruling:

- **One Size Does Not Fit All**. Although the *Toys "R" Us* deal protections provide comfort that similar protections will be acceptable in other *Revlon* transactions where the target has been similarly shopped, the court was careful to emphasize that deal protections are evaluated based on the specific facts of a transaction—in particular, the extent to which the target was shopped and the concessions received by the target in exchange for the deal protections. The deal protections approved in *Toys "R" Us* are not necessarily appropriate in all *Revlon* transactions.
- **Measure Breakup Fees by Equity Value**. Although the *Toys "R" Us* court upheld a breakup fee equal to 3.75% of the equity value, the judge noted consistently in his analysis that the breakup fee amounted to 3.25% of the enterprise value (which adds together the consideration paid and the target's outstanding debt less cash on hand). Measuring breakup fees in terms of enterprise value rather than equity value is a more accurate way to evaluate the effect that the fee has in discouraging higher bids. This is consistent with the Delaware Court of Chancery's analysis in another recent case (*In re MONY*), and may reflect a trend in Delaware of evaluating breakup fees in terms of percentage of enterprise value rather than equity value.
- **Beware of Billion-Dollar Breakup Fees**. The court indicated that breakup fees should decline on a percentage basis as transaction size increases. The ruling noted that the Court of Chancery should not "be entirely immune to the preclusive differences between termination fees starting with a 'b' rather than an 'm'."

Section 2115 generally applies if:

- a foreign corporation conducts a certain amount of its business in California (based on property, payroll and sales calculations); and
- more than 50% of its outstanding voting securities are held of record by persons having California addresses.

If a corporation is subject to the quasi-California corporation statute, a number of California corporate law provisions apply (purportedly to the exclusion of the law of the corporation's jurisdiction of incorporation), including provisions that directly or indirectly affect M&A transactions. These provisions—and their counterparts under Delaware law—address:

- shareholder approval requirements in acquisitions (which are generally more extensive than the approval requirements under Delaware law);
- dissenter's rights (which differ from Delaware law in a number of respects);

- limitations on corporate distributions (which are significantly more restrictive than Delaware law);
- indemnification of directors and officers (which is more limited than in Delaware);
- mandatory cumulative voting in director elections (permitted but not required in Delaware); and
- the availability of the California "fairness hearing" procedure to approve the issuance of stock in an M&A transaction (an alternative to SEC registration that has no counterpart in Delaware law).

Since the state of incorporation may take the view that its law, rather than California law, governs, conflicting legal requirements are possible, and careful transaction planning is required if a non-California corporation is deemed a "quasi-California" corporation.

Fairness Hearings

In M&A transactions involving the issuance of stock, California law offers a relatively efficient and inexpensive alternative to SEC registration that still results in essentially freely tradable stock—a "fairness hearing" authorized by Section 3(a)(10) of the Securities Act of 1933. An acquiror that is eligible to use a fairness hearing can avoid the greater expense and delay associated with an SEC registration and the complications that may follow an SEC review of a registration statement.

The procedure is available where either party to the transaction is a California corporation—or a quasi-California corporation as discussed above. Fairness hearings have also been used where a significant number of the target's shareholders are California residents, regardless of the parties' places of incorporation.

A fairness hearing is conducted before a hearing officer of the California Department of Corporations. Unlike an SEC review, which assesses the accuracy and completeness of disclosures, the fairness hearing process is a review of the substantive fairness of the transaction terms. The hearing officer reviews some of the disclosure documents, but there are few rules governing their content, and the documents—a notice to shareholders of the hearing, followed by an information statement—are much less extensive than a proxy statement or registration statement governed by SEC rules.

Fairness hearings are, at least in theory, open to the public. Notice of hearing dates is posted at the offices of the Department of Corporations, but it is extremely rare for a member of the general public to appear at a fairness hearing. However, it is possible for a competing bidder to appear at the hearing and contest the fairness of the transaction—for example, by making a higher bid on the spot.

Non-Competition Agreements

Courts in some jurisdictions are reluctant to enforce non-competition agreements on the grounds that they are contrary to public policy. The enforcement of non-competition agreements in California is particularly problematic, because a California statute provides that non-competition agreements are unenforceable except in very limited circumstances, such as in connection with the sale of a business.

In addition, California courts generally will not enforce a non-competition agreement governed by the laws of another state unless the non-competition agreement would be enforceable under California law. Since there is a reasonable possibility that a former employee against whom an out-of-state technology company seeks to enforce a non-competition agreement may be a resident of California at the time enforcement is sought, this limitation can prevent a company from enforcing in California an otherwise valid non-competition agreement entered into when the employee resided in another state.

As a result of these limitations, companies located outside of California that are accustomed to signing non-competition agreements with employees must change their practices when acquiring a business located in, or expanding into, the California market.

Stock Options

Unless a private company limits the total number of worldwide participants in a stock option plan to 35 (plus an unlimited number of "accredited investors" who meet standards of high income or high net worth that most employees cannot meet), it must include—in any option plan in which California employees participate—several provisions that can cause practical problems or limit its flexibility:

- ***Minimum vesting rate:*** Options granted to employees who are not officers or directors must become exercisable at a rate of no less than 20% per year over five years from the date of grant. This requirement may make it impossible for the company to grant performance-based options to non-management employees.
- ***Minimum exercise period following termination:*** Unless the optionee is terminated for cause, an option may be exercised (to the extent vested) for at least six months following termination for death or permanent and total disability, and for at least 30 days following any other termination.
- ***Annual financial statements:*** The company must provide annual financial statements to each optionee. This requirement can be problematic for small, privately held companies.

In order to avoid extending these rights to all plan participants, some private companies adopt special "California Supplements" that contain the required provisions and are applicable to California employees only. The California rules described above do not apply to public companies whose option shares are registered with the SEC on a Form S-8.

Jury Trials

In 2005, the California Supreme Court invalidated prospective jury trial waivers. As a result, parties wishing to avoid jury trials can no longer rely on prospective waivers in acquisition or other agreements governed by California law, and must specify other dispute resolution mechanisms. Arbitration and other ADR provisions remain enforceable. ■

Tender offers can enable friendly acquisitions to be completed more quickly by eliminating the delays associated with preparing and mailing a merger proxy statement and holding a stockholder meeting to approve the acquisition. Lingering uncertainty over the application of the SEC's "best-price" rule, however, has discouraged some buyers from using tender offers. A new SEC proposal, if adopted, would eliminate much of this uncertainty and thus remove a significant impediment to more widespread use of tender offers for friendly acquisitions.

Background

Federal law requires that target stockholders in a tender offer be provided with adequate information about the terms of the tender offer and receive fair and equal treatment. Current SEC Rule 14d-10 provides, in part, that all target stockholders must be paid the highest consideration paid to any target stockholder (commonly referred to as the "best-price rule").

Over time, a split has emerged among the US federal courts regarding whether and how the best-price rule should be applied to stay bonuses, severance packages and other compensation paid to target company executives in deals that are structured as tender offers. Some courts have found that these arrangements constituted additional consideration for the executives' stock. This conclusion would require that all target stockholders be paid an amount per share equal to the largest amount per share received by any target company executive—determined by dividing each executive's additional compensation by the number of shares held, and adding such amount to the price per share offered to all other target stockholders. This could result in a preposterously high amount per share.

Although not all courts have adopted this interpretation of the best-price rule, the possibility of this draconian outcome has been widely perceived to be a significant risk. As a result, in recent years, parties to friendly acquisitions have routinely structured deals as mergers—where the best-price rule is inapplicable—rather than tender offers.

SEC Proposal

In December 2005, the SEC proposed amendments to clarify that the best-price rule applies only with respect to consideration paid for the securities tendered in the tender offer and not the consideration paid pursuant to employment compensation, severance or other employee benefit arrangements, absent unusual circumstances indicating that these arrangements really are consideration for the securities. The proposal would also create a safe harbor that, if available, would protect the arrangements from challenge. The proposals would apply only to third-party tender offers and not issuer self-tenders.

The SEC stated that the amendments were intended to:

- clarify that compensatory arrangements between employees or directors of the target company, on the one hand, and the bidder or the target company, on the other hand, are not captured by the best-price rule;
- alleviate the uncertainty that various court interpretations of the best-price rule have produced; and
- remove any unwarranted incentive to structure transactions as mergers, to which the best-price rule does not apply, instead of tender offers, to which it does apply.

In proposing the amendments, the SEC acknowledged the commercial reality that key employees—without regard to their stock ownership—may represent a significant portion of the value in a target company's continuing business, or that it may be advantageous for those employees to be replaced or terminated following an acquisition. The SEC further noted that critical personnel decisions often need to be made concurrently with acquisition decisions to ensure that key employees remain with the target company or to ensure a smooth transition for employees who will not remain after the transaction is completed.

Proposed Amendments

Rule 14d-10(a)(2), as proposed to be amended, would provide that a bidder shall not make a tender offer unless "the consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer." The phrase "for securities tendered in the tender offer" would replace the phrases "pursuant to the tender offer" and "during such tender offer" in the current rule.

In addition, the proposed amendments would add a safe harbor from the best-price rule in third-party tender offers for:

"The negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such arrangements, with respect to employees and directors of the subject company, where the amount payable under the arrangement: (i) relates solely to past services performed or future services to be performed or refrained from performing, by the employee or director (and matters incidental thereto); and (ii) is not based on the number of securities the employee or director owns or tenders."

In order to get the benefit of the new safe harbor, the arrangement must be approved by the target company's independent compensation committee members or other independent directors, or by the bidder if the bidder pays the additional compensation.

Likely Impact

If adopted, the proposed amendments would remove the obstacle currently posed by conflicting case law regarding the negotiation and payment of stay bonuses, severance packages and other compensation to target company executives in deals that are structured as tender offers. Thus, the proposal should result in an increased number of friendly tender offers. ■

We reviewed all merger transactions involving venture-backed targets signed up or consummated in 2004 and 2005 (as reported in VentureSource)—a total of 54 transactions in 2004 and 39 transactions for 2005—where the merger documentation was publicly available and the deal value was $25 million or more. Of the 2004 merger transactions, 23 (or 43%) were for cash, 22 (or 41%) were for stock and nine (or 17%) were for a mixture of cash and stock. Of the 2005 transactions, 27 (or 69%) were for cash, four (or 10%) were for stock and eight (or 21%) were for a mixture of cash and stock.

Based on this review, we have compiled the following deal data:

Deals with Earn-Out		2004	2005
Deals that provided contingent consideration based upon post-closing performance of the target (other than balance sheet adjustments)	With Earn-Out	24%	15%
	Without Earn-Out	76%	85%

Deals with Indemnification		2004	2005
Deals where the target's shareholders or the buyer indemnified the other post-closing for breaches of representations, warranties and covenants	With Indemnification		
	By Target's Shareholders	89%	100%
	By Buyer[1]	37%	46%

Survival of Representations and Warranties		2004	2005
Length of time that representations and warranties survived the closing for indemnification purposes[2]	Shortest	6 Months	9 Months
	Longest	36 Months	24 Months
	Most Frequent	12 Months	12 Months

Caps on Indemnification Obligations		2004	2005
Upper limits on indemnification obligations where representations and warranties survived the closing for indemnification purposes	With Cap	85%	100%
	Limited to Escrow	72%	79%
	Limited to Purchase Price	7%	5%
	Exceptions to Limits[3]	74%	73%
	Without Cap	15%	0%

[1] *The buyer provided indemnification in 48% of the 2004 transactions and 25% of the 2005 transactions where buyer stock was used as consideration. In 65% of the 2004 transactions and 17% of the 2005 transactions where the buyer provided indemnification, buyer stock was used as consideration.*

[2] *Measured for representations and warranties generally; specified representations and warranties may survive longer.*

[3] *Generally, exceptions were for fraud and willful misrepresentations.*

Escrows		2004	2005
Deals having escrows securing indemnification obligations of the target's shareholders	With Escrow	83%	97%
	% of Deal Value		
	Lowest	4%	2%
	Highest	23%	20%
	Most Frequent	10%–20%	10%
	Length of Time		
	Shortest	6 Months	6 Months
	Longest	36 Months	24 Months
	Most Frequent	12 Months	12 Months
	Exclusive Remedy	64%	84%
	Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy[4]	72%	66%

Baskets for Indemnification		2004	2005
Deals with indemnification where a specified "first dollar" amount did not count towards indemnification, expressed either as a "deductible" (where such amount can never be recovered) or as a "threshold" (where such dollar amount cannot be recovered below the threshold but once the threshold is met all such amounts may be recovered)	Deductible	39%	38%
	Threshold	51%	62%

MAE Closing Condition		2004	2005
Deals where the buyer or the target had as a condition to its obligation to close the absence of a "material adverse effect" with respect to the other party or its business	Condition in Favor of Buyer	81%	82%
	Condition in Favor of Target[5]	30%	13%

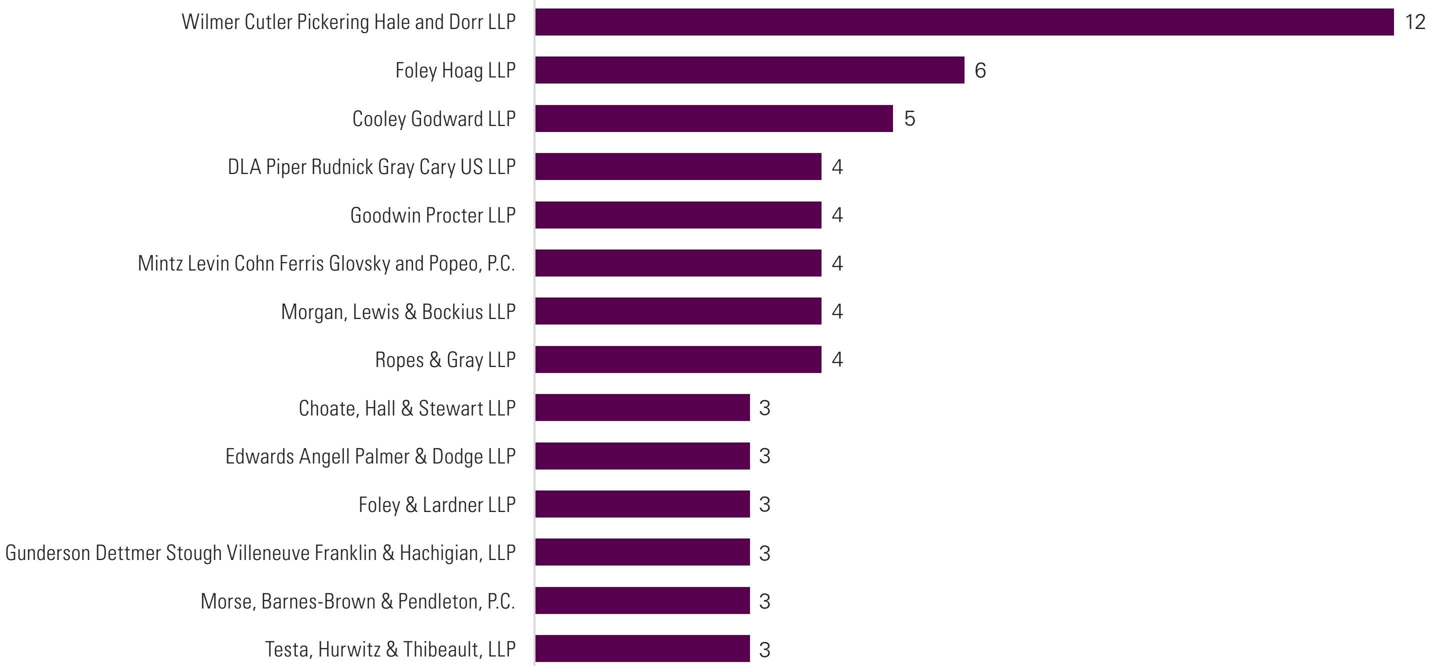
Exceptions to MAE		2004	2005
Deals where definition of "material adverse effect" for the target contained specified exceptions	With Exception[6]	78%	79%

[4] *Generally, exceptions were for fraud and criminal activity.*

[5] *In 50% of these transactions in 2004 and in 80% of these transactions in 2005, buyer stock was used as consideration.*

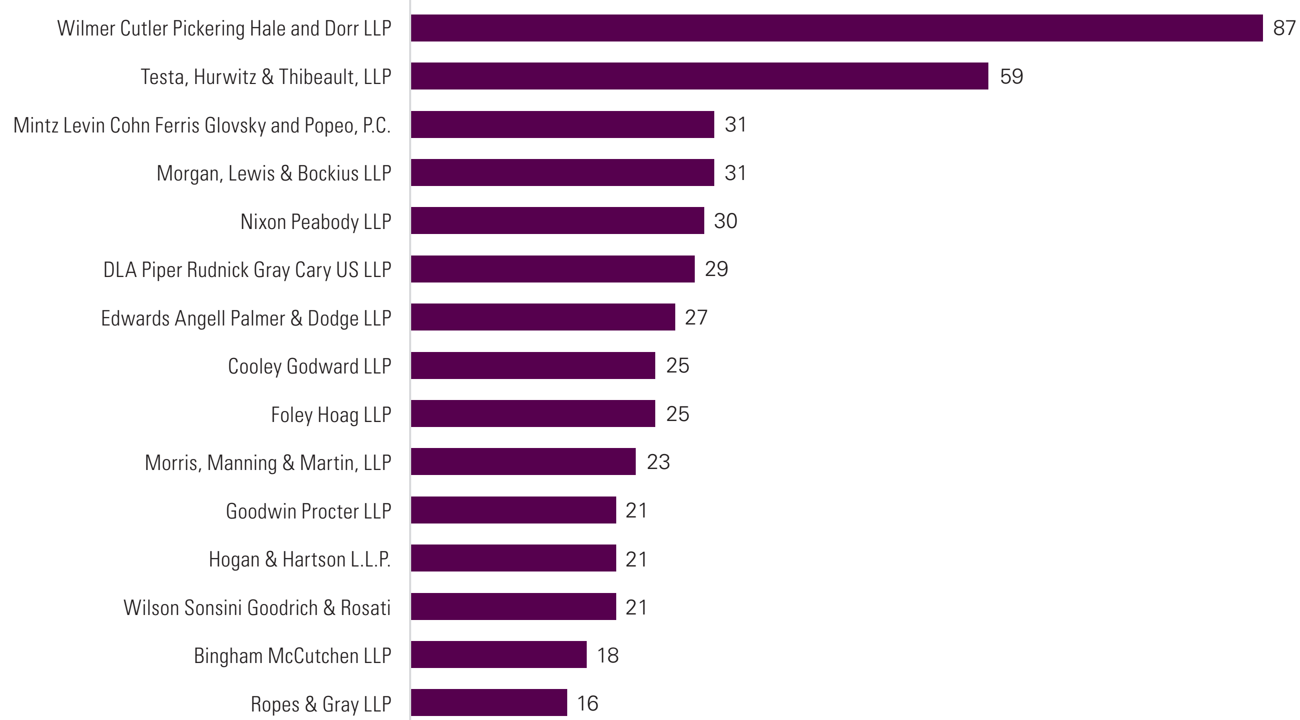
[6] *Generally, exceptions were for general economic and industry conditions.*

Counsel in Sales of Eastern US VC-Backed Companies in 2005



Source: VentureOne

Counsel in Sales of Eastern US VC-Backed Companies – 1996 to 2005



The above charts are based on companies located east of the Mississippi River.
Source: VentureOne

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See our *2005 IPO Report* for a detailed analysis of the 2005 IPO market and 2006 outlook. The report features regional IPO market breakdowns, a review of the PIPEs and Rule 144A markets, insight on the recent securities law reforms, recommendations for pre-IPO companies grappling with new twists on cheap stock issues, and a discussion of the emergence of AIM as a possible alternative to Nasdaq for US high-growth companies.

Our *2005 Venture Capital Report* offers an in-depth review of the US and European venture capital markets and discusses the outlook for 2006. Other highlights include industry and regional breakdowns, practical advice on option grant valuations under new IRS rules on deferred compensation, an overview of trends in VC deal terms, a review of venture capital fundraising activity, and a look ahead to the evolution of more robust accounting and financial controls for VC funds.

To request a copy of the *2005 IPO Report* or the *2005 Venture Capital Report*, or to obtain additional copies of the *2005 M&A Report*, please contact the WilmerHale Marketing and Business Development Department at marketing@wilmerhale.com or call +1 617 526 5600. An electronic copy of this report can be found at www.mergerleader.com.

Data Sources

M&A data is sourced from MergerStat. Data for sales of VC-backed companies is sourced from VentureOne. For law firm rankings, sales of VC-backed companies are included under the current name of each law firm.

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